

FINANCIAL REPORTING, TAXATION & ACCOUNTING

SEC Staff Comfortable With New Flexibility In Non-GAAP Disclosure

ABSTRACTED FROM: *Telling Your Story: The SEC Offers Advice On Non-GAAP Measures*

BY: David Lynn and Nilene Evans

Morrison & Foerster, Washington DC (DL) and New York NY (NE)

Insights: *Corporate & Securities Law Advisor*, Vol. 24, No. 3, Pgs. 36-38

Keep the story straight. The SEC's Regulation G applies when a publicly held company discloses information that includes a financial measure not in compliance with GAAP. Attorneys David Lynn and Nilene Evans remind registrants of recent comments by the Division of Corporation Finance staff, indicating that statements made outside a company's SEC filings are also subject to SEC review. For example, an issuer may want to break out for the public the earnings per share attributable to a certain new initiative that is not usually allowed by GAAP. The SEC staff will scrutinize that and other non-GAAP statements. The information being disseminated must be consistent with the data in the company's SEC filings.

New interpretations offer new flexibility. The Compliance and Disclosure Interpretations (C&DI) issued by the SEC staff in early 2010 covers non-GAAP financial measures [**Editor's Note:** available at www.sec.gov/divisions/corpfin/guidance/nongAAPinterp.htm] and replaces previously issued guidelines. In the authors' view, this document shows a new level of flexibility in how the SEC will implement the non-GAAP disclosure rules. For example, an issuer may disclose recurring item adjustments as long as it does not identify an item as "non-recurring, infrequent or unusual." Registrants may disclose per-share performance measures, provided the company also explains the purpose of the disclosure. Free cashflow may be publicized, along with the related calculation, and a measure of EBITDA (earnings before interest, taxes, depreciation, and appreciation) is now permitted, along with related covenant disclosures. Some rules have not changed: with limited exceptions for foreign private issuers, companies still cannot issue non-GAAP income statements.

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Editor's Note: Because of the vacation publishing schedule, the July and August issues of the *Bowne Digest* are shortened. The full-length newsletter will return in September 2010.

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Seeking consistency in disclosures. Most non-GAAP disclosures continue to carry additional information requirements, indicating that the SEC did not issue a carte blanche on non-GAAP disclosures. The SEC staff has made it clear that it does not encourage non-GAAP information but nevertheless wants the public to receive the best information possible. The staff routinely reviews all company filings as well as other forms of communication such as earnings calls, press releases, and other public statements or communications. The authors indicate that the staff will be paying special attention to any inconsistencies between the GAAP information in the SEC filings and other public statements, so be consistent in disclosures—whatever the form.

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CORPORATE GOVERNANCE & DIRECTORS' DUTIES

Quality Or Quantity? How Much And What Information Do Decisionmakers Need?

ABSTRACTED FROM: *Method In The Madness: A Practical Checklist For Corporate Directors*

BY: Roger Lane and Courtney Worcester, Pepper Hamilton, Boston MA

The Corporate Board, Vol. 30, No. 178, Pgs. 1-4

When is “too much” not enough? Corporate boards these days face an overload of diverse, complex, and critical issues, a glut that can overwhelm thoughtful directors. Compliance professionals hoping to ward off liability might think that piling on the information and data in each director’s packet is wise. Yet, litigators Roger Lane and Courtney Worcester caution, quantity is no substitute for quality. To help, the authors have formulated a checklist for corporate directors to follow in reaching decisions. The principles in the checklist also apply to management and corporate counsel who participate in the decisionmaking process. The first task is to decide what information the directors will need. Start by identifying precisely what every item on the meeting agenda is asking the directors to do. Keep in mind that the board oversees, but does not act as, management. The process of defining tasks will clarify what and how much information the directors will need. Receiving a periodic status update, for example, calls for the least amount of information, while making a final decision on a major corporate issue calls for the most. The quality of the information can affect the extent to which courts and regulators might later defer to the board’s actions.

It bears repetition: pump up the preparation. Obviously, directors should take enough time to get ready for meetings; and managers and outside advisors should provide them with the necessary information well in advance so they have enough time for review. Tailor the information to each action that the board is requested to take; and, the authors stress, present it in a form that the directors (who might not all be familiar with the subject matter) can understand. Include information that is available in-house and that outside advisors have neither condensed nor interpreted, although raw computer databases typically are not useful. Use a delivery system with which the directors are comfortable. For example, some board members might prefer hard copies to e-mails or PDF files.

Give advisors whose views carry weight a good workout. When an agenda item involves a specific area of professional expertise (such as law, accounting, or investment or commercial banking), the directors will certainly seek the help of outside advisors. The board must make a determination that

these advisors are knowledgeable and have no conflicts of interest. The board must also decide if any directors or executives have actual or possible conflicts of interest (concerning, e.g., executive compensation or personal financial interests in company transactions). If conflicts exist, make sure that recusals, special board committees, or other suitable protective measures are in place. The board should confirm with corporate counsel or other advisors that the proposed actions and related procedures comply with all applicable laws and regulations; with existing contracts, which might necessitate third-party consents; and with in-house governance requirements, including the corporate charter, bylaws, shareholder agreements, and option plans.

Press boards to flex their deliberative muscles. Management must give the directors enough time to deliberate—to explore the issues and to examine relevant information and advice—before they have to arrive at a decision. While the amount of time naturally depends on the types of decisions and the surrounding circumstances, an emergency might demand immediate action. The board and its committees ought to document everything done with contemporaneously taken minutes or written consents. Minutes should describe the deliberations; explain the protective measures put in place because of conflicts of interest; and include suitable exhibits, such as contracts approved and non-privileged reports. Laws, regulations, and credit agreements will dictate which actions taken must be disclosed, when, and in what detail. The authors' final checkpoint suggests that everyone step back before decisions are final and consider whether any aspect of the decisionmaking process appears to have been incomplete or unclear.

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SECURITIES REGULATION & DISCLOSURE

When The Sea Rises, Disclose The Effects Of Climate Change

ABSTRACTED FROM: *The SEC Interpretive Release On Climate Change Disclosure*

BY: Jeffrey Smith, Matthew Morreale, and Kimberley Drexler, Cravath Swaine & Moore, New York NY
Review of Securities & Commodities Regulation, Vol. 43, No. 7, Pgs. 95-101

At last, an interpretive release. An SEC interpretive release that became effective in early 2010 may help compliance professionals understand the requirements for disclosing climate-change concerns. Environmental lawyers Jeffrey Smith, Matthew Morreale, and Kimberley Drexler highlight four sectors that could give rise to a need for disclosure: present and pending laws and regulations (e.g., the costs under the cap-and-trade system); international agreements on combatting climate change; business trends indirectly resulting from climate change (e.g., decreases in demand by green-conscious consumers); and the physical effects of climate change (e.g., the impact of rising sea levels on a factory situated near the ocean). After two years of stalemate, the Commission finally approved the release, albeit by just a 3-2 vote. The release followed a request from Ceres (a coalition of environmental public interest groups and investors), institutional investors, New York State's Attorney General, state treasurers, and corporate officials. The requestors sought guidance on when companies must disclose risks related to climate change.

How Reg. S-K applies. The Ceres petition requested that issuers be required to evaluate the effects of climate change on their operations, supply and distribution chains, and personnel. Item 101, Item 103, the MD&A section, and Item 503 under Reg. S-K may all be applicable to climate-change disclosures. Item 101 requires disclosure of the effects on capital expenditures, earnings, and competitive position from complying with environmental protection laws, so issuers should monitor legislative changes and the consequences of various regulatory choices. Under Item 103, which covers disclosure of material legal proceedings and administrative actions, a diverse and growing array of climate-change litigation may be pertinent, the authors advise. For example, three courts in late 2009 considered whether climate-change remedies are appropriate for judicial decision or should be left to the executive or legislative branch; they also evaluated who has standing to sue. The MD&A section requires an issuer to disclose known trends and uncertainties—such as climate change—that will probably have a material effect on liquidity, capital resources, net sales, or income. Management must assume that an event will occur unless it can conclude that the event is not reasonably likely, and disclosure is required unless the event is not reasonably likely to affect the company materially. Risk factors that must be disclosed under Item 503 include physical risk to facilities or operations.

Implications of the new approach. The SEC always wants issuers to avoid generalized disclosures that could apply to any company, but the new release might encourage self-protective disclosures (which might obscure the consequences of climate change). Although companies need not reveal their carbon footprint, the calculation of emissions could provide the basis for some required disclosure of business trends under Item 303 or strategic planning under Item 101. One commissioner commented that issuers disclosing the effects of pending climate-change legislation must determine whether they can effectively calculate greenhouse-gas emissions. The release clearly brings climate change under the SEC's general disclosure requirements; as a result, disclosure control procedures will apply. The authors advise issuers to determine whether to include—in their SEC filings—any climate-change disclosures they have made in other vehicles. If including disclosures from alternate sources, the issuer will need to ensure that appropriate disclosure control procedures were in place.

Accounting standards come into play as well. Applying accounting standards to climate-change concerns, the authors warn, is not an easy task. The FASB's Accounting Standards Codification Topic 450, which codified FAS No. 5, is now the most frequently applied in the environmental area. It requires that a loss contingency be accrued and the contingency described in a footnote if the loss is "probable" and the amount can be "reasonably estimated." If the loss is only "reasonably possible" or the amount cannot be estimated, then the company does not need to accrue it but must explain it in a footnote. SEC Staff Accounting Bulletin No. 92 requires that issuers measure liabilities by using available facts and existing technology and legislation. When a range of reasonable likely outcomes exists, the company must recognize the lowest amount in the range. Determining whether an event is probable and whether a liability can be estimated will be complicated when considering climate change and will vary by industry, company, plant, and locale.

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Editor's Note: To read the full text of the release, visit www.sec.gov/rules/interp/2010/33-9106.pdf. For more about the SEC's interpretive guidance on its climate-change requirements, read "Climate Change Disclosure" by Catherine Dixon and Ellen Odoner, *Insights: Corporate & Securities Law Advisor*, Vol. 24, No. 3, Pgs. 2-8.

What To Do When The SEC Comes Calling

ABSTRACTED FROM: *The SEC Has A Few Questions For You*

BY: Sarah Johnson

CFO, May 2010, Pgs. 25-28

Queries on the rise. SEC reviews have become more likely in recent years: the regulators sent letters to more than 2,200 companies during 2009, a 73% increase over 2005. This trend makes it imperative for compliance professionals and CFOs to prepare filings and financial statements carefully, Sarah Johnson suggests, and to craft an effective response. The Sarbanes-Oxley Act requires the Commission to review public companies' filings at least once every three years. Certain characteristics, such as extreme levels of stock volatility or very large market capitalizations, may also draw scrutiny. While a review can lead to an amended filing or restatement, it usually results in the issuer promising to provide greater detail in its future filings.

Issues of concern. The scope and focus of the reviews vary, depending on what the current hot-button issues are (remember fair-value accounting?) or, the author suggests, even how much time reviewers have to focus on a particular company. In 2010, issuers can expect to see certain topics take center stage: disclosures in the management's discussion and analysis section, non-GAAP financial measures, risk disclosures relating to climate change, and goodwill impairments. In the wake of pay scandals at financial firms, the SEC also appears primed to scrutinize compensation and incentive pay performance targets for top executives.

Crafting a response. Compliance professionals can prepare for SEC reviews by addressing key issues of concern. In the MD&A section, for instance, the SEC wants a more detailed and colorful description of operating results, capital resources, and liquidity, as well as the process used for developing key accounting estimates. Companies must test goodwill impairment (one of 2009's hot topics) when a drop in stock price or other triggering event occurs. Reviewers will also look for consistency in non-GAAP reporting over press releases, websites, and regulatory filings. Disclosure controls, segment reporting for business units, fair-value measurements, and related-party transactions are other issues of concern. Although CFOs are usually not involved directly in responding to SEC questions, the author notes, they can help drive the process by keeping the chief executive, outside advisors, and board members on top of developments. Hire outside advisors with experience in responding to SEC inquiries, and refrain from drawing conclusions until all parties involved have examined the question thoroughly. A spirit of constructive engagement, rather than an adversarial tone, will help move the process along.

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